



COUNCIL AGENDA: 11-4-14
ITEM: 3.4

Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Toni J. Taber, CMC
City Clerk

SUBJECT: SEE BELOW

DATE: 10-23-2014

**SUBJECT: 2013-14 ANNUAL PERFORMANCE AUDIT OF TEAM SAN JOSÉ'S
MANAGEMENT OF THE CITY'S CONVENTION AND CULTURAL
FACILITIES**

RECOMMENDATION

As recommended by the Public Safety, Finance, and Strategic Support Committee on October 16, 2014 and outlined in the attached memo previously submitted by the Public Safety, Finance, and Strategic Support Committee, accept the 2013 – 14 Annual Performance Audit of Team San José's Management of the City's Convention and Cultural Facilities.



Office of the City Auditor

**Report to the City Council
City of San José**

**2013-14 ANNUAL
PERFORMANCE AUDIT OF
TEAM SAN JOSE'S
MANAGEMENT OF THE
CITY'S CONVENTION AND
CULTURAL FACILITIES**

**Report 14-09
October 2014**

October 09, 2014

Honorable Mayor and Members
Of the City Council
200 East Santa Clara Street
San José, CA 95113

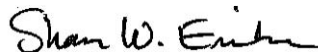
2013-14 Annual Performance Audit of Team San Jose's Management of the City's Convention and Cultural Facilities

Since 2004, the San José McEnery Convention Center and several other facilities have been operated on the City's behalf by Team San Jose, Inc. Under the terms of the Management Agreement between the City and Team San Jose (TSJ), the City Auditor annually audits TSJ's management of the Facilities. Our objective is to determine whether, and how well, TSJ achieved its agreed-upon performance goals and incentive fee targets that are the basis for the City's incentive payments to TSJ.

Team San Jose Achieved a Weighted Incentive Fee Score of 120 Percent. In FY 2013-14, TSJ drew 1.3 million people to events at the Facilities and booked 255,000 future hotel room nights. It surpassed its fiscal performance targets. It met all economic impact targets. It achieved its customer service goal and two theater performance goals. Altogether, TSJ achieved a weighted incentive fee score of 120 percent and thus qualifies for the maximum incentive fee of \$350,000.

We will present this report at the October 16, 2014 meeting of the Public Safety, Finance, and Strategic Support Committee. We would like to thank Team San Jose and the City Manager's Office for their time and cooperation during the audit process. The Administration has reviewed and agrees with the information in this report.

Respectfully submitted,



Sharon W. Erickson
City Auditor

finaltr
SE:lg

Audit Staff: Minh Dan Vuong

cc: Karolyn Kirchgesler	Jim Shannon
Ed Shikada	Dave Costain
Jennifer Maguire	Elizabeth Klotz
Janette Sutton	David Powell
Lee Wilcox	

This report is also available online at <http://www.sanjoseca.gov/audits>.

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Introduction

The mission of the City Auditor's Office is to independently assess and report on City operations and services. The audit function is an essential element of San José's public accountability and our audit reports provide the City Council, City management, and the general public with independent and objective information regarding the economy, efficiency, and effectiveness of City operations and services.

In accordance with the City Auditor's fiscal year (FY) 2014-15 Audit Work Plan, we have completed an audit of Team San Jose, Inc.'s (TSJ) management of the City's Convention and Cultural Facilities to determine whether TSJ met the performance measures specified in the *Agreement for the Management of the San José Convention Center and Cultural Facilities Between the City of San José and Team San Jose, Inc.* (Management Agreement) for FY 2013-14.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We limited our work to those areas specified in the "Audit Objective, Scope, and Methodology" section of this audit report.

We thank Team San Jose and the City Manager's Office for their time, information, insight, and cooperation during the audit process.

Background

The San José Convention and Cultural Facilities (the Facilities) consist of the San José McEnery Convention Center, the City National Civic, Parkside Hall, South Hall, the Center for the Performing Arts, the California Theatre, and the Montgomery Theater. These seven venues offer trade shows, conventions, corporate meetings, social events, consumer shows, and performing arts.

Team San Jose, Inc., a non-profit corporation, was formed in December 2003 in response to the City's request for proposal (RFP) for the management and operations of the Convention Center, which was formerly managed by the City's Department of Convention, Arts, and Entertainment. TSJ has a 15-member board of directors that includes representatives from local hotels, arts, business, and labor. It also includes a City Council liaison and an ex-officio member from

the City Manager's Office. The City's Management Agreement with TSJ requires the City Auditor's Office to conduct an annual audit of the performance measures in the agreement.¹

Contract History

The City entered into a Management Agreement with Team San Jose to operate and manage the Facilities for the five-year period from July 1, 2004 through June 30, 2009. On August 13, 2009, the City exercised its option to extend the original term for one additional five-year period through June 30, 2014.

A June 2009 addendum to the Management Agreement clarified performance measures and incentive pay.

In August 2010, the City issued TSJ a notice of default because TSJ's FY 2009-10 expenditures had exceeded its operating budget by more than \$750,000, without an appropriation adjustment, a violation of the Management Agreement's terms. This resulted in a number of actions including an expanded performance audit by the City Auditor, and the City Council later directed the City Manager to begin development of an RFP for management of the Convention Center and Cultural Facilities and services provided under the Convention and Visitors Bureau (CVB).

In March 2011, the Council adopted a second amendment to the Management Agreement that reflected recommendations from the City Auditor's FY 2009-10 Performance Audit. As of June 30, 2011, Team San Jose was no longer in default of the Management Agreement, and in December 2011, the Council voted to discontinue work on the Request for Proposal for the management of the Facilities.

In September 2012, the Council adopted a third amendment to the Management Agreement, effective FY 2012-13, to clarify and redefine the methodology for the *gross operating profit* and *return on investment* performance measures.

In June 2014, the City and TSJ entered into a new Management Agreement for the period of July 1, 2014 through June 30, 2019, with two additional five-year options. The new Management Agreement gives TSJ the ability to modify its Adopted Budget, revises the theater performance measures, changes the management fee and incentive fee amounts,² and puts TSJ in charge of standard capital improvements and repairs. This audit, however, concerns TSJ's FY 2013-14 performance and thus follows the terms of the 2009-2014 Management Agreement and its amendments.

¹ Our previous audits are available online at <http://www.sanjoseca.gov/audits>.

² The new Management Agreement reduces the incentive fee from a maximum of \$350,000 to \$200,000. It increases the management fee from \$750,000 to \$1 million.

Convention Center Expansion

The Convention Center recently underwent renovation and expansion. Construction began in Summer 2011, though the most disruptive work began in Summer 2012. The expansion added an additional 125,000 square feet of flexible ballroom and meeting room space, increasing San José's Convention Center space to 550,000 square feet of usable space. The Convention Center was open during construction and celebrated grand re-opening events in October 2013.

Audit Objective, Scope, and Methodology

The objective of our audit was to determine whether TSJ met its performance and incentive fee measures for FY 2013-14. To do so we:

- Obtained and reviewed relevant documents including: the Management Agreement and its addendum and amendments, Council-adopted performance targets for FY 2009-10 to 2013-14, TSJ's performance reports, the FY 2013-14 final audited financial statement for the Facilities, the Convention Center debt service schedule, parking garage revenue and expense reports, Budget Office reports for the Convention and Cultural Affairs Fund (Fund 536), TSJ's attendance and theater records, the agreed-upon procedures for hotel-room night bookings performed by *Petrinovich Pugh & Company, LLP* on TSJ's behalf, and TSJ's customer service surveys for the year
- Interviewed management and staff from TSJ, as well as from the City Manager's Office of Economic Development and Budget Office about the performance measures and TSJ's accomplishments for the year
- Tested the accuracy and completeness of TSJ's recording of the number of occupied and performance days for theaters, and attendance at convention and cultural events during the year
- Tested the accuracy of TSJ's computation of gross revenue, gross operating profit, and return on investment using the audited financial statements and the Management Agreement's methodologies, and its estimation of economic impact using approved economic models.

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Finding I Team San Jose Met All Its Targets in FY 2013-14

Summary

In FY 2013-14, TSJ drew 1.3 million people to events at the Facilities and booked 255,000 future hotel nights. The Management Agreement requires Team San Jose to report annual performance compared to targets established by the City. In addition to surpassing financial targets for gross revenue and gross operating profit, TSJ met all four of its performance measures for economic impact: hotel room nights, event attendance, estimated economic impact, and return on investment. TSJ also met its performance targets for customer satisfaction and its two theater measures, occupied days and performance days. In aggregate, TSJ achieved a weighted incentive fee score of 120 percent and thus qualifies for the maximum incentive fee of \$350,000.

The Performance-Based Agreement Between the City and Team San Jose Establishes Performance and Incentive Fee Measures

The 2009-2014 Management Agreement outlines eight performance measures that track Team San Jose's economic impact, financials, theater performance, and customer survey results. Six of those measures, plus a measure of gross revenue, are used to determine incentive pay – the “incentive fee measures.”³ Exhibit I shows these measures and their weighting.

Exhibit I: Weights on the Performance Measures and on the Incentive Fee Measures

Performance Measures		Incentive Fee Measures	
Economic Impact	40%	Economic Impact	40%
Hotel Room Nights (10%)		Hotel Room Nights (15%)	
Attendance (10%)		Attendance (10%)	
Estimated Economic Impact (10%)		Estimated Economic Impact (15%)	
Return on Investment (10%)			
Gross Operating Profit	40%	Gross Revenue	40%
Theater Performance	10%	Theater Performance	10%
Performance Days (7%)		Performance Days (7%)	
Occupied Days (3%)		Occupied Days (3%)	
Customer Satisfaction Survey	10%	Customer Satisfaction Survey	10%
Total	100%	Total	100%

Source: Second Amendment to Management Agreement between the City and Team San Jose.

³ Because construction of the facilities managed by TSJ was financed through tax-exempt debt, the management contract cannot, according to the City Attorney's Office, have an incentive pay provision that is based on return on investment or net profit; hence, the incentive fee measures used to determine TSJ's incentive pay differ slightly from the general performance measures.

For FY 2013-14, the City Set Performance Targets Near or Slightly Below Performance Achieved in the Year Prior

Incentive contracts, such as the City's Management Agreement with Team San Jose, have been common in government for several decades. In 1998 *Best Practices for Performance-Based Service Contracting*,⁴ the White House Office of Management and Budget described performance-based contracts as follows:

Performance-based service contracting... is designed to ensure that contractors are given freedom to determine how to meet the Government's performance objectives, that appropriate performance quality levels are achieved, and that payment is made only for services that meet these levels.

Concerning incentives, the best practices caution that:

Care must be taken to ensure that the incentive structure reflects both the value to the government of the various performance levels, and a meaningful incentive to the contractor. Performance incentives should be challenging yet reasonably attainable. The goal is to reward contractors for outstanding work, but not penalize them for fully satisfactorily but less than outstanding work.

Under the 2004-2009 management agreement, targets were set during contract negotiations for the entire five-year term of the agreement. Under the 2009-2014 agreement, TSJ is required to submit annual targets for the City's review and joint agreement. The City has incorporated the target setting into its budget process.

From FY 2009-10 to 2012-13, the City's setting of "challenging yet reasonably attainable" targets was impacted by external factors.⁵ During this period, the City generally lowered targets because of economic uncertainty and anticipated disruptions from the Convention Center's renovation and expansion. In hindsight, the City expected construction would begin sooner than it did and may have overestimated construction impacts (or underestimated TSJ's ability to mitigate the impacts).

For FY 2013-14, the City had set performance targets near or slightly below performance achieved in FY 2012-13. According to the City Manager's Office, this reflected industry-wide assumptions that FY 2013-14 was anticipated to be a slower year than FY 2012-13, with fewer meetings and events.⁶ In fact, as shown below, TSJ outperformed its own prior-year achievements on six measures.

⁴ Although the Best Practices document was subsequently rescinded, its overall message is echoed in Federal Acquisition Regulation and in the National Institute of Government Purchasing's guidance on performance-based contracting.

⁵ **Appendix B** shows TSJ's performance and targets since FY 2004-05.

⁶ City Council meeting December 3, 2013, item 3.8: <http://www.sanjoseca.gov/DocumentCenter/View/24146>

The City documented the detailed target setting and detailed formulas in emails. In the future, clear documentation will be especially important for transparency as the 2014-2019 Management Agreement allows for budget and target adjustments throughout the year.

Team San Jose Met and Exceeded all of its Performance and Incentive Targets in FY 2013-14

Based on our review of the audited financial statements,⁷ third-party reviews of hotel room night bookings, and Team San Jose's attendance, customer satisfaction, and theater records, we found that Team San Jose:

- Met targets for all eight of the performance measures
- Met targets for all seven of the incentive fee measures

TSJ's performance against each target is shown in Exhibit 2, as are the calculations of the weighted performance score and the weighted incentive fee score.

Exhibit 2: Team San Jose's FY 2013-14 Weighted Performance and Incentive Fee Scores

Measures	Target	Result	% of Goal	Performance		Incentive Fee	
				Weight	Score	Weight	Score
Economic Impact							
Hotel Room Nights	242,500	255,466	105%	10%	10.5%	15%	15.8%
Event Attendance	1,050,000	1,274,046	121%	10%	12.1%	10%	12.1%
Estimated Economic Impact	\$80,000,000	\$91,136,382	114%	10%	11.4%	15%	17.1%
Return on Investment	2.42	2.45	101%	10%	10.1%	n/a	n/a
Gross Revenue and Gross Operating Profit							
Gross Revenue	\$21,350,000	\$28,534,534	134%	n/a	n/a	40%	53.5%
Gross Operating Profit	\$4,500,000	\$6,590,305	146%	40%	58.6%	n/a	n/a
Theater Performance							
Occupied Days	628	704	112%	3%	3.4%	3%	3.4%
Performance Days	322	365	113%	7%	7.9%	7%	7.9%
Customer Service							
Satisfaction Rate	95%	98%	103%	10%	10.3%	10%	13.3%
Weighted Performance/Incentive Fee Score					124.3%	120.0%	

Source: Auditor analysis of the 2009-2014 Management Agreement and its addendum and amendments, FY 2013-14 audited financial statements, event attendance reports, and other Team San Jose records.

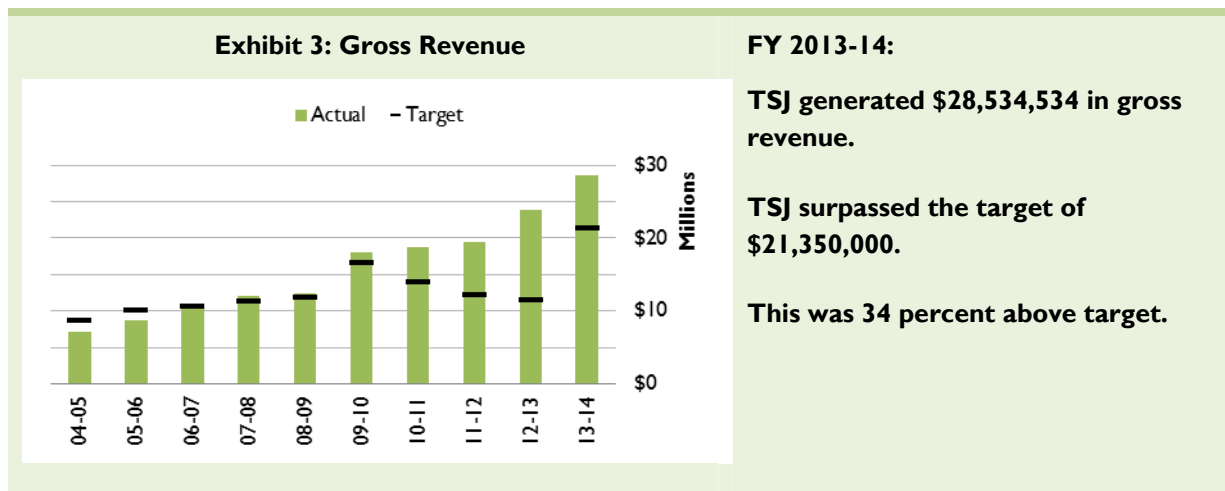
Note: weighted percentages are the product of the measure weights listed in Exhibit 1, and actual performance as a percentage of the goal. For instance, Event Attendance is given a weighted incentive fee score of 12.1 percent because the result of 1,274,046 was 121 percent of the target of 1,050,000, and the amended Management Agreement assigns Event Attendance a weight of 10 percent.

⁷ The financial audit of the City's Convention and Cultural Facilities, by the independent accounting firm of Macias, Gini, and O'Connell, was completed in October 2014 with a clean opinion: <http://www.sanjoseca.gov/DocumentCenter/View/35975>.

In the following sections, we describe each performance measure in detail and show multi-year trends. **Appendix A** summarizes the methodology for calculating each individual measure in detail. In addition, **Appendix B** gives a one-page overview of TSJ's results and targets for performance and incentive fee measures since FY 2004-05.

Team San Jose Met Its Target for Gross Revenue

Gross revenue, as shown in Exhibit 3, is the revenue generated from the operation of the Facilities.

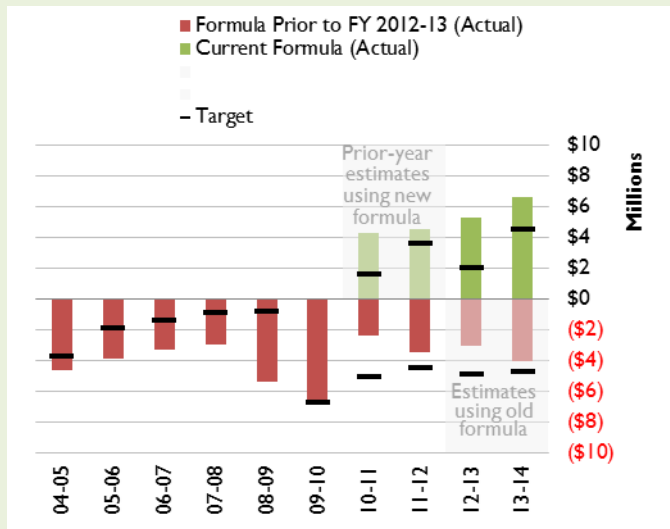


Source: Auditor analysis of the Management Agreement and its third amendment, audited financial statements for the Convention and Cultural Affairs Fund, and our prior TSJ audits.

It should be noted that actual gross revenue has been much higher since FY 2009-10 compared to prior years – largely, but not entirely, because TSJ brought food and beverage services in-house. The gross revenue of \$28.5 million in FY 2013-14 rose \$4.8 million higher compared to the prior year. The increase, again, was largely driven by food and beverage revenue, and additionally by building rental and event production labor revenues.

Team San Jose Met Its Target for Gross Operating Profit

The Management Agreement's definition of gross operating profit is gross revenue (as described above) minus direct and indirect expenses related to the operation of the Facilities. TSJ's results are shown in Exhibit 4.

Exhibit 4: Gross Operating Profit**FY 2013-14:**

Gross operating profit was \$6.6 million.⁸

TSJ surpassed the target of \$4.5 million.

This was 46 percent above target.

Source: Auditor analysis of the Management Agreement and its amendments, audited financial statements for the Convention and Cultural Affairs Fund, parking garage revenue and expense reports, Budget Office reports for the Convention and Cultural Affairs Fund, and prior TSJ audits.

The calculation did **not** include the City's \$15.3 million payment in FY 2013-14 for debt service for the Convention Center's original construction, nor did it include the \$6.9 million payment for debt service for the recent renovation and expansion, in accordance with the Management Agreement.

The Gross Operating Profit Formula Has Changed

It is important to note that the definition for Gross Operating Profit was revised effective FY 2012-13 by the third amendment to the Management Agreement. On the revenue side, new additions were: hotel tax revenues (formally known as Transient Occupancy Tax, TOT) allocated to the Convention and Cultural Affairs Fund⁹ as well as Convention Center parking garage revenues. On the expense side, CVB expenses funded by the Convention and Cultural Affairs Fund and

⁸ In August 2014, TSJ reported a gross operating profit of \$5.7 million for FY 2013-14. Our calculation is \$0.9 million higher because TSJ used early Transient Occupancy Tax revenue estimates and the annual financial audit of the Convention and Cultural Facilities adjusted year-end expenses. TSJ's report can be found here: <http://sanjoseca.gov/DocumentCenter/View/34079>.

⁹ The Facilities, under TSJ's management, generate revenues which help fund operations. However, to continue its operations, TSJ relies on operating transfers from the Transient Occupancy Tax Fund, which collects the City's hotel taxes. Currently, approximately 30 percent of TOT collections are transferred to the Convention and Cultural Affairs Fund (Fund 536).

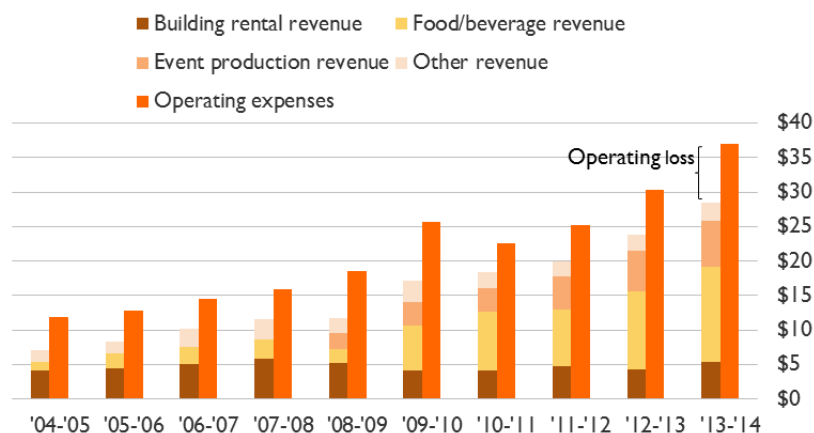
Approximately 30 percent are split between CVB and the Office of Cultural Affairs and the remaining 40 percent of TOT collections go to the City's General Fund. To the extent that TSJ's net operating loss (from the accounting perspective) is less than the TOT revenue transferred into the Convention and Cultural Affairs Fund, remaining TOT funds from the year fall to fund balance.

parking garage expenses now factor into the calculation. For comparison purposes, Exhibit 4 shows the negative gross operating profits (i.e., losses) under the old formula as red bars, whereas the new formula is drawn as green bars.

The Financial Statements Show an Operating Loss

In contrast to the gross operating profit results, the audited financial statements for the Convention and Cultural Facilities show an operating loss of \$8.5 million in FY 2013-14, calculated in accordance with Generally Accepted Accounting Principles.¹⁰ Exhibit 5 shows a ten-year history of operating revenues and expenses, whose difference yields the operating profit or loss, calculated in accordance with Generally Accepted Accounting Principles. Every year, the Facilities were operating at a loss, requiring an operating contribution ranging between \$4.1 million and \$8.5 million from the City.

Exhibit 5: Operating Revenues and Expenses in Accordance with Generally Accepted Accounting Principles, in \$millions



Source: Audited financial statements for the Convention and Cultural Affairs Fund.

The audited financial statements for the Convention Center and Cultural Facilities caution:

In order for the Center to continue its operations, it relies on the City for operating contributions. The operating loss for the year was \$8,511,467, inclusive of \$2,926,066 in building upgrades and major repairs, which required operating cash contribution totaling \$8,472,803 from the City. The City uses a portion of TOT from its Transient Occupancy Tax Special Revenue Fund to fund these contributions. Accordingly, any significant changes in the TOT or a decision to change the amount of support could greatly affect the Center's ability to continue as a going concern.

¹⁰ Audited financial statements, 2013-14: <http://www.sanjoseca.gov/DocumentCenter/View/35975>

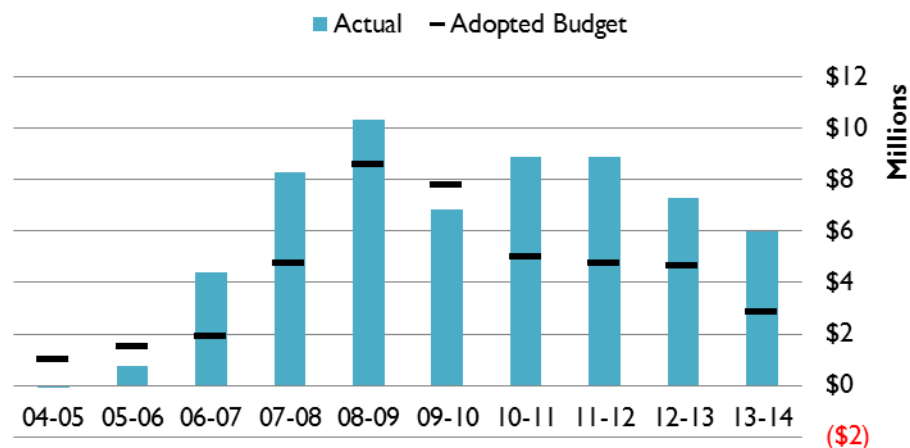
As noted in prior reports, when TSJ performs better than expected (as it did from FY 2010-11 to FY 2013-14), it reduces the chance that reimbursements from the City's General Fund would be required. Indeed, the City has not made a significant transfer from the General Fund to the Convention and Cultural Affairs Fund since FY 2009-10.

Exhibit 7 on the next page reconciles the audited financial statements to the Management Agreement's definitions of gross revenue and gross operating profit.

The Ending Balance in the Convention and Cultural Affairs Fund Has Declined

Overall, during FY 2013-14, the Convention and Cultural Affairs Fund's ending balance declined by \$1.3 million, from \$7.3 million to \$6.0 million, in part due to capital improvements at Cultural Facilities. The ending fund balance, however, was \$3.2 million higher than expected. This was the third year of a decrease in the ending balance after significant capital improvements. Generally, the ending balance indicates the availability of funds for future use. It includes a capital reserve of \$2.4 million, as of October 2014. Exhibit 6 shows a ten-year history of the Fund's ending balance, as adopted at the beginning of the fiscal year and actually closed at the end of the fiscal year.

Exhibit 6: Ending Balance of the Convention and Cultural Affairs Fund (Fund 536)



Source: Source and Use Statements in Adopted Budgets.

Exhibit 7: Reconciliation of the Management Agreement's Measures to the Audited Financial Statements (FY 2013-14)

	Audited Financial Statements	Adjustments (per 2009-2014 Management Agreement)	
		Formula Prior to FY 2012-13	Current Formula
Operating Revenues:			
Building rental	\$ 5,428,565		
Food and beverage services	13,767,102		
Commission revenue	1,688,369		
Event electrical/utility services	461,053		
Audio/visual services	278,914		
Ticketing services	286,406		
Telecommunications services	84,627		
Equipment rentals	60,839		
Event production labor revenues	6,613,118		
Other revenues	2,921		
Less: City of San José credits for facility usage	(137,380)	\$ 137,380 a	
Total Operating Revenues	28,534,534	28,671,914	
Transient Occupancy Tax revenue to Convention and Cultural Affairs Fund			\$ 8,769,780 b, c
Parking garage revenue			3,125,803 b
Revenues for gross operating profit calculation			40,567,497
Operating Expenses:			
Administrative and general salaries – TSJ	12,026,058		
Cost of event production labor	6,227,291		
Utilities	2,733,494		
Food and beverage costs	2,610,688		
Bad debt expense	20,457		
Contracted outside services	3,282,787		
Professional services	732,839		
Operating supplies	458,318		
Depreciation	817,166	(817,166) a	
Repairs and maintenance	1,310,042		
Insurance	271,666		
City of San José oversight	1,085,998	(1,085,998) a	
Ticketing costs	71,886		
Workers' compensation insurance premiums	909,267		
Fire insurance	225,504	(225,504) a	
Management and incentive fee – Team San Jose	1,080,791	(600,000) a	(480,791) b, d
Equipment rentals	146,168		
Repairs and maintenance – City funded	1,616,024	(1,616,024) a	
Other expenses	1,419,557		
Total Operating Expenses	37,046,001	32,701,309	
City use expense			137,380 b
CVB expenses paid by Convention and Cultural Affairs Fund			499,996 b
Total operating expenses for return on investment calculation			32,857,894
Parking garage expenses			1,119,298 b
Expenses for gross operating profit calculation			33,977,192
Gross Operating Profit or (Loss)	\$(8,511,467)	\$(4,029,395)	\$ 6,590,305

Source: Auditor's analysis of FY 2013-14 audited financial statements for the San José Convention and Cultural Facilities, and the Management Agreement between Team San Jose and the City and its amendments, parking garage revenue and expense reports, and Budget Office reports for the Convention and Cultural Affairs Fund.

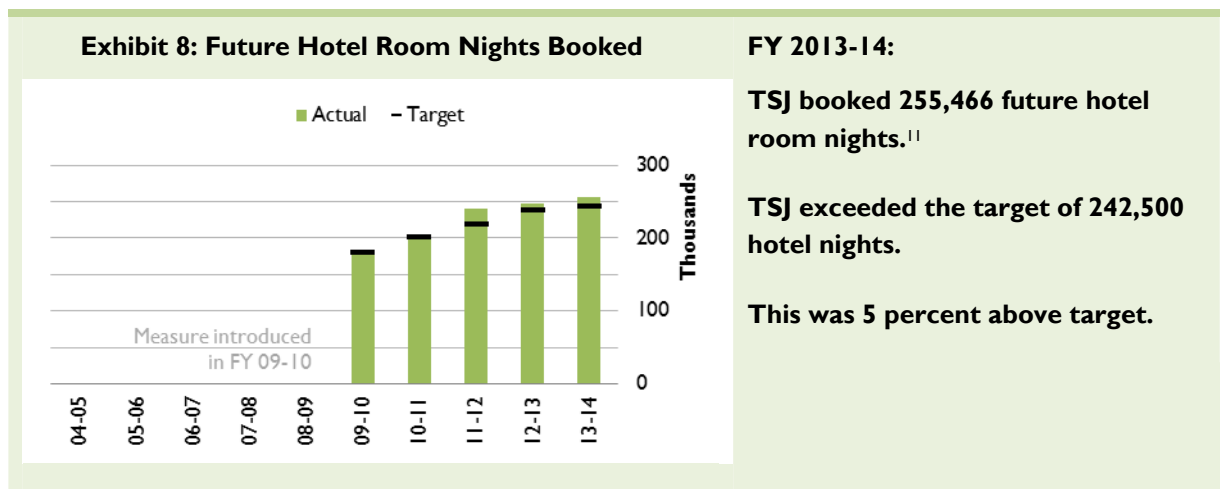
Notes:

- Change made to calculate gross revenue and gross operating profit in accordance with the Management Agreement and its amendments (i.e., reverse the revenue deduction for City of San José facility usage; and deduct from total expenses depreciation, City oversight, fire insurance, the fixed executive management fee, and City-funded repairs and maintenance).

- (b) Change made to calculate gross operating profit in accordance with the Management Agreement's third amendment (i.e., include the Transient Occupancy Tax allocation to the Convention and Cultural Affairs Fund, Convention Center parking garage revenues and expenses, and CVB expenses paid by the Convention and Cultural Affairs Fund, and exclude the fixed minimum management fee and incentive fee).
- (c) In accordance with emails between the City Manager's Office and TSJ, Transient Occupancy Tax was calculated using Budget Office figures as follows: FY 2013-14 actuals of \$8,459,788, plus \$334,916 attributable to FY 2013-14 but to be booked in FY 2014-15 actuals, minus \$14,924 attributable to FY 2012-13 but booked into FY 2013-14 actuals. To reconcile year-end results, the Budget Office books some amounts into future fiscal years.
- (d) The Fixed Minimum Management Fee is \$150,000. TSJ also received a Fixed Executive Management Fee of \$600,000 to pay for a portion of executive salaries and benefits. In addition, TSJ received \$350,000 as incentive fee. Together these fees make up the City's payment of \$1.1 million for Team San Jose's management of the Facilities in FY 2013-14.

Team San Jose Met Its Target for Hotel Room Nights

Hotel room nights booked, as shown in Exhibit 8, is measured as the total number of **future** hotel room nights booked by Team San Jose over the course of the fiscal year.



Source: Auditor analysis of the Management Agreement and its amendments, TSJ's hotel room nights production report, third-party reviews of TSJ's hotel room night bookings, and our prior TSJ audits.

TSJ met its hotel night goal in each of the five years it has reported on the measure.

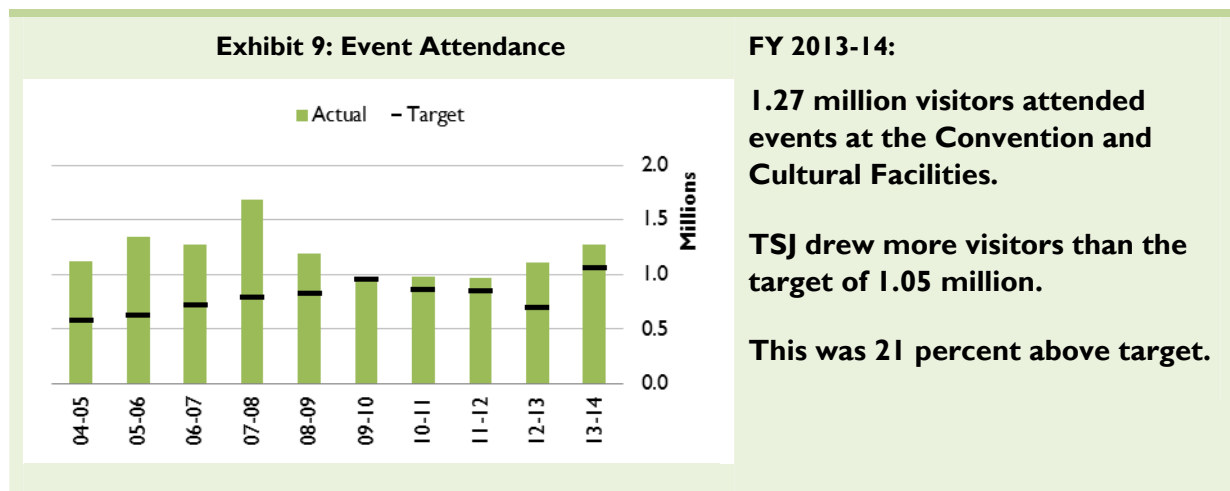
The City's target-setting memorandum anticipated 2013-14 being a "slower year, with meetings and events down," yet according to TSJ, it outdid its prior-year performance by "developing and retaining Sales talent and [emphasizing] consistent market segmentation."

¹¹ 20,000 of the future hotel room nights were booked on the last three business days of FY 2013-14, which is not unusual according to TSJ.

The 255,466 hotel room nights also included about 3,000 that were cancelled by the event organizers after FY 2013-14.

Team San Jose Met Its Target for Event Attendance

Event attendance, as shown in Exhibit 9, is the number of local/social visitors, out-of-town visitors, and exhibitors who attend events at the Convention and Cultural Facilities.



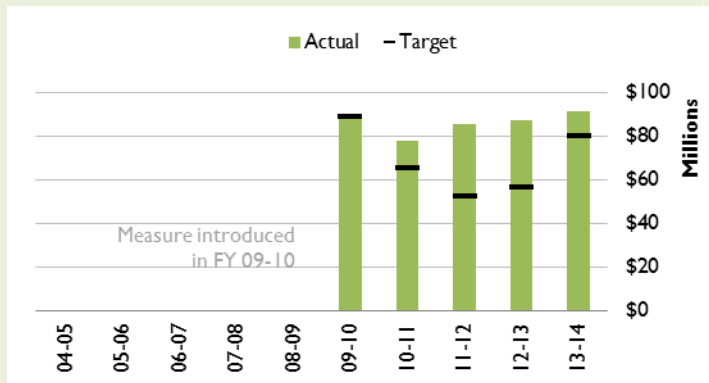
Source: Auditor analysis of the Management Agreement and its amendments, TSJ event attendance reports, and our prior TSJ audits.

The two largest events drawing attendance were the 2014 Silicon Valley International Auto Show (340,000) and “Star Wars” presented by The Tech Museum of Innovation (162,000). These accounted for 39 percent of the total visitor count. The remaining events drew between 10 and 28,000 visitors.

Although attendance was down from a peak in FY 2007-08, TSJ has achieved its targets for attendance in nine of its ten years in charge of the Facilities. The City had anticipated FY 2013-14 to be a slower year with fewer meetings and events compared to the prior year. TSJ attributed its success to corporate events that its sales team attracted in the short term.

Team San Jose Met Its Target for Estimated Economic Impact

Estimated economic impact is an average daily spending rate multiplied by event attendance and duration. Average daily spending rates vary depending on event type (i.e., conventions and meetings, spectator sports and demonstrations, and participant sports and competitions) and attendee type (i.e., local/social visitors, out-of-town visitors, and exhibitors). For example, it is assumed that a local sports participant will spend \$18 or that an out-of-town visitor at a convention will spend \$242 in the City’s economy. Exhibit 10 shows the results for estimated economic impact.

Exhibit 10: Estimated Economic Impact**FY 2013-14:**

TSJ estimated an economic impact of \$91.1 million.

Estimated economic impact exceeded the target of \$80.0 million.

This was 14 percent above target.

Source: Auditor analysis of the Management Agreement and its amendments, and TSJ event attendance reports, TSJ's estimated economic impact calculations, and our prior TSJ audits.

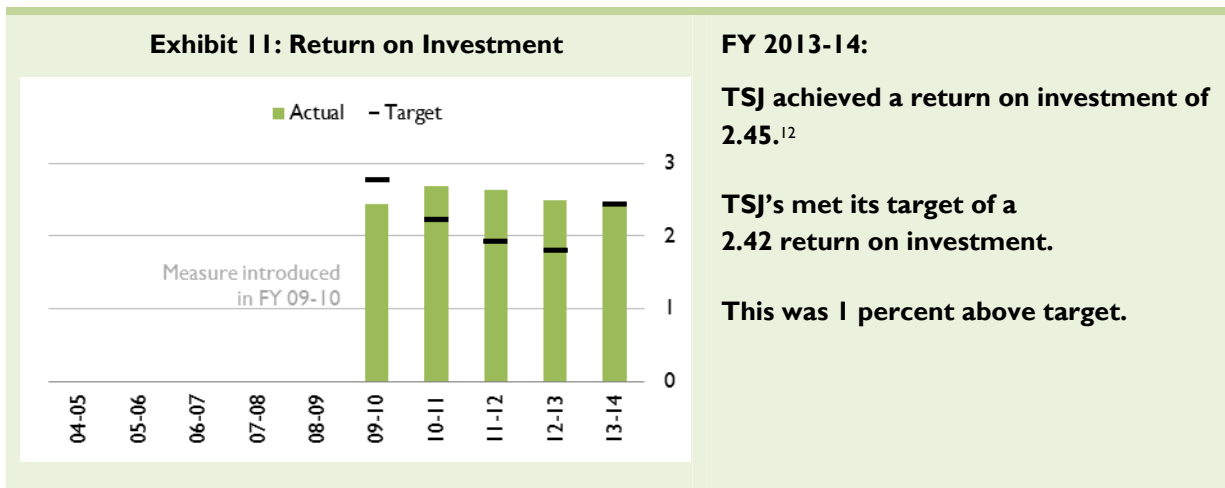
The three largest events generating estimated economic impact were: FanimeCon 2014 (\$11.5 million), the 2014 Silicon Valley International Auto Show (\$9.1 million), and the 2014 Conference on Lasers and Electro-Optics (\$4.0 million). These three events contributed 27 percent towards TSJ's estimated economic impact.

TSJ has met its estimated economic impact targets each of the five years it has reported on the measure. This measure is driven entirely by event attendance and the assumed spending rates.

Team San Jose Met Its Target for Return on Investment

The Management Agreement's broad definition of return on investment is the sum of gross revenues from the operation of the Facilities, estimated economic impact, parking garage revenues, and the Transient Occupancy Tax allocation to the Convention and Cultural Affairs Fund; divided by the sum of expenses paid for the operation of the Facilities, Facilities debt service, parking garage expenses, and **some** other expenses paid by the Convention and Cultural Affairs Fund.

The intent is to measure the amount of financial benefit generated from the operation of the Facilities and CVB as compared to the cost of generating such benefits. Exhibit 11 shows TSJ's results.



Source: Auditor analysis of the Management Agreement and its third amendment, audited financial statements for the Convention and Cultural Affairs Fund, the Convention Center debt service schedule, TSJ's estimated economic impact and return on investment calculations, parking garage revenue and expense reports, and our prior TSJ audits.

Note: Components included and excluded from the calculation changed in FY 2013-14.

TSJ achieved its return on investment goal every year except FY 2009-10. Since FY 2010-11, TSJ has outperformed its goals for return on investment, because it is a formula-driven measure that increases when its inputs, especially estimated economic impact and gross revenue, increase.

The Return on Investment Formula Is not Traditional

It is important to note that this does **not** mean that the Convention and Cultural Affairs Fund received \$2.45 in net profit for every \$1 invested, as would be suggested by the traditional calculation of return on investment (i.e., the traditional definition of return on investment is net profit divided by investment).

Instead, the Management Agreement's broad definition of return on investment is largely driven by estimated economic impact; that is to say, it measures spending in San José's economy as a result of conventions and other events (i.e., at restaurants, at the Airport, for transportation, and in hotels and retail establishments).

¹² TSJ reported an ROI of \$2.38 in its August 2014 year-end report. It was using the formula for the 2014-2019 Management Agreement and thus counting various capital expenditures. TSJ's report can be found here: <http://sanjoseca.gov/DocumentCenter/View/34079>.

The Return on Investment Formula Excludes Certain Expenses

Certain expenses paid by the Convention and Cultural Affairs Fund did **not** factor into the calculation of return on investment, including:

- Convention Center expansion/renovation costs of \$10.6 million – would have lowered return on investment by 0.40
- Debt service of \$6.9 million for the Convention Center expansion, paid for by a 4 percentage point increase in Transient Occupancy Taxes (approved in June 2009) – would have lowered return on investment by 0.26
- The management fee of \$750,000 paid by the City to Team San Jose – would have lowered return on investment by 0.03 (it had factored into the FY 2012-13 calculation, but the City Manager's Office and Team San Jose agreed to leave it out)
- Capital improvements at the City National Civic and Center for the Performing Arts of \$444,000 – would have lowered return on investment by 0.02
- The incentive fee of \$350,000 paid by the City to Team San Jose – would have lowered return on investment by 0.02

Exhibit 12 shows how return on investment was calculated for FY 2013-14.

Exhibit 12: Components of Return on Investment

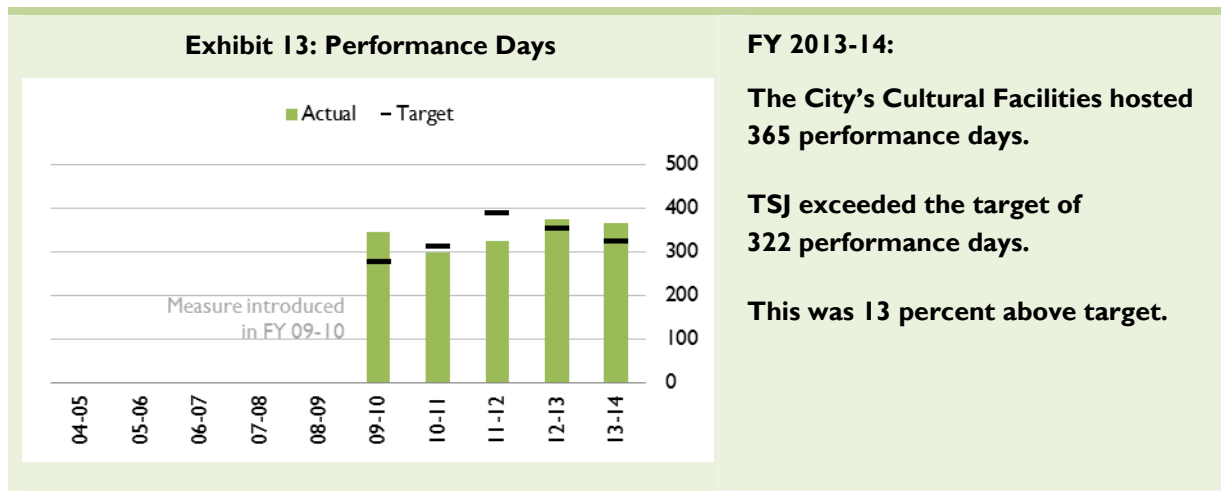
<i>\$91.1 million</i> <i>Est. economic impact</i>	+	<i>\$28.5 million</i> <i>TSJ operating revenue</i>	+	<i>\$8.8 million</i> <i>TOT revenue to Fund 536</i>	+	<i>\$3.1 million</i> <i>Parking revenue</i>	
<i>\$15.3 million</i> <i>Debt service</i>	+	<i>\$32.9 million</i> <i>TSJ operating expenses</i>	+	<i>\$4.5 million</i> <i>Some Fund 536 expenses</i>	+	<i>\$1.1 million</i> <i>Parking expenses</i>	= 2.45

Source: Auditor analysis of the Management Agreement and its third amendment, audited financial statements for the Convention and Cultural Affairs Fund, the Convention Center debt service schedule, TSJ's estimated economic impact and return on investment calculations, parking garage revenue and expense reports, and our prior TSJ audits.

For Transient Occupancy Tax (TOT), see Exhibit 7, footnote (c). Fund 536 is the Convention and Cultural Affairs Fund.

Team San Jose Met Its Target for Performance Days

Performance days, as shown in Exhibit 13, are the number of days on which a performance takes place at the Cultural Facilities.



Source: Auditor analysis of the Management Agreement and its amendments, TSJ's theater records, and our prior TSJ audits.

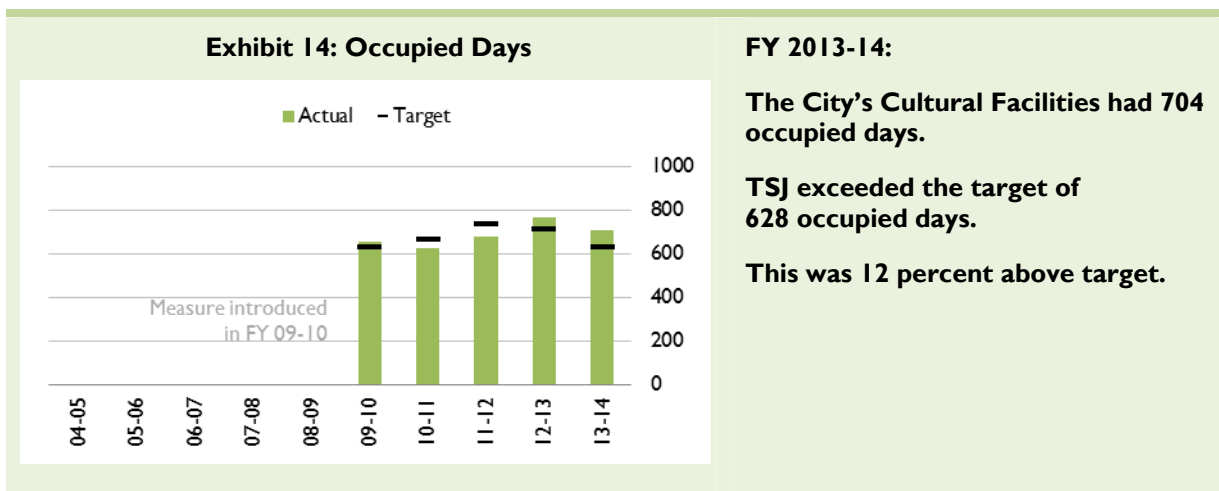
TSJ reported that 135 of these 365 performance days were contributed by the City's resident art partners – Symphony Silicon Valley, the Children's Musical Theater of San Jose, Opera San Jose, and Ballet San Jose.¹³

¹³ For this performance measure, events spanning multiple fiscal years are counted solely in the fiscal year in which the events conclude for theater performance and other performance measures.

Additionally, during the course of the FY 2011-12 performance audit, we learned that one cultural facility can have multiple "performance days" on a single calendar day if the venue hosts unique performances (i.e., if the California Theatre hosts a youth symphony performance in the afternoon and a choir performance in the evening, TSJ counts two performance days). Further, performance days may include days on which a cultural facility hosts private showings (i.e., if the California Theatre hosts an invitation-only opera performance, the day count as a performance day even though the show was not a public ticketed event). The goal of theater performance measures is to track "activation" of cultural facilities (in other words, the number of times these facilities drew people downtown).

Team San Jose Met Its Target for Occupied Days

Occupied days, as shown in Exhibit 14, are the number of days that a theater is utilized under contract and not available for booking for other events.



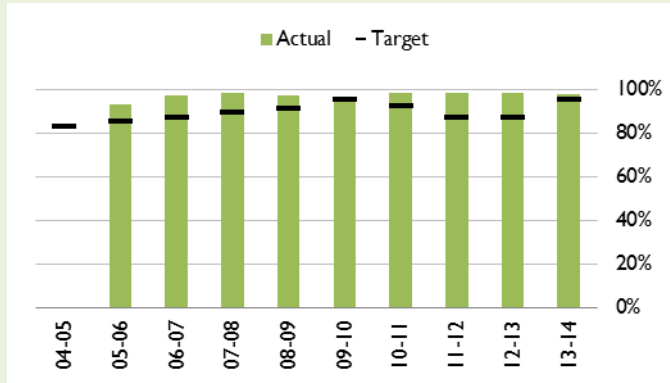
Source: Auditor analysis of the Management Agreement and its amendments, TSJ's theater records, and our prior TSJ audits.

The targets and achievements for performance days and occupied days were lower than in the prior year because some performing arts partners had fewer planned performances and the Center for the Performing Arts was closed in the first quarter for a fire system upgrade.

Team San Jose Met Its Target for Customer Satisfaction

Customer satisfaction, as shown in Exhibit 15, is the percentage of event coordinators who responded to a customer survey with an overall satisfactory rating of the product and services provided. Responses of "excellent," "very good," or "good" are considered satisfactory.

Exhibit 15: Customer Satisfaction



FY 2013-14:

98 percent of TSJ customers were satisfied.¹⁴

TSJ exceeded the target of 95 percent satisfaction.

This was 3 percent above target.

Source: Auditor analysis of the Management Agreement and its amendments, TSJ's customer service survey results, prior TSJ audits.

The response rate was about 44 percent. For customer satisfaction, Team San Jose has met its targets for all but one of the past ten years.¹⁵

Team San Jose Achieved a Weighted Performance Score of 124 and an Incentive Fee Score of 120 Percent in FY 2013-14

As shown above, Team San Jose met its targets for all eight of the performance measures. In accordance with the Management Agreement, this resulted in a total weighted performance score of 124 percent. TSJ also met its targets for all seven of the incentive fee measures, resulting in a total weighted incentive fee score of 120 percent (see Exhibit 2 above).

Team San Jose received \$750,000 in management fees in FY 2013-14 as a base payment. In addition to these payments, the City makes incentive payments based on TSJ's performance.

The Management Agreement includes incentive fee targets and a corresponding incentive fee structure, along with performance measures. The performance and incentive fee measures provide a quantifiable way of evaluating TSJ's management of the Convention and Cultural Facilities. In the FY 2009-10 performance audit, we recommended that the incentive fee payment structure be revised such that TSJ receives incentive payments only if it achieves a specified threshold. This was accomplished by separating what was previously known as the "incentive fee" into

¹⁴ The 120 customer service survey responses included 80 excellent, 31 very good, 6 good, 2 fair, and 1 poor scores.

¹⁵ Insufficient customer responses were collected in FY 2004-05 to present a meaningful rating.

two components, the Fixed Minimum Management Fee and the incentive fee.¹⁶ In our prior analysis, we also found that the incentive fee was not structured to incentivize performance that exceeds expectations. The incentive fee schedule has since been revised and is shown in Exhibit 16.

Exhibit 16: Incentive Fee Payment Schedule

Weighted Incentive Fee Score	Incentive Fee Amount
Less than 100%	No incentive fee
At least 100% but less than 110%	\$200,000
At least 110% but less than 115%	\$300,000
115% or greater	\$350,000

Source: Second Amendment to Management Agreement between Team San Jose and the City.

Team San Jose achieved a weighted incentive fee score of 120 percent for FY 2013-14 and therefore qualifies for the maximum incentive fee of \$350,000.

¹⁶ The Fixed Minimum Management Fee is \$150,000. TSJ also received a Fixed Executive Management Fee of \$600,000 to pay for a portion of executive salaries and benefits. In addition, TSJ received \$350,000 as incentive fee. Together these fees make up the City's payment of \$1.1 million for Team San Jose's management of the Facilities in FY 2013-14.

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Conclusion

In FY 2013-14, Team San Jose met all targets on its nine measures. It surpassed its fiscal performance targets. It met all economic impact targets. It achieved its customer service goal and two theater performance goals. Altogether, TSJ achieved a weighted incentive fee score of 120 and thus qualifies for the maximum incentive fee of \$350,000.

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APPENDIX A

Methodology for Calculating Performance and Incentive Fee Measures

Measures	Type of Measure	Methodology for Calculation
Gross Revenue and Gross Operating Profit		
Gross Revenue	Incentive only	Those revenues from operation of the Facilities excluding revenue billed by TSJ on behalf of other vendors providing services to clients of the Facilities.
Gross Operating Profit	Performance only	<p>The third amendment to the Management Agreement, effective September 2012, changed the methodology for the gross operating profit calculation to be: Revenues (as described above) plus Transient Occupancy Tax (TOT) revenue allocated to the Convention and Cultural Affairs Fund and net Convention Center parking garage revenue (i.e., the revenue received from parking garage operations less the City's cost to operate the garage) minus direct and indirect expenses related to the operation of the Facilities and CVB funding from the Convention and Cultural Affairs Fund.</p> <p>Per the agreement and its amendments, we did not include the following expenditures in calculating gross operating profit: the fixed executive management fee, fixed minimum management fee, incentive fee, depreciation expense, City contract oversight costs, fire insurance, or City-funded repairs and maintenance.</p>
Economic Impact		
Hotel Room Nights	Performance and Incentive	Measured as the total number of future hotel room nights booked by the CVB over the course of the Fiscal Year and the total number of future hotel room nights booked that can be directly or indirectly attributed to activities at the Facilities.
Event Attendance	Performance and Incentive	Number of local/social visitors, out-of-town visitors, and exhibitors who attend events at the Convention and Cultural Facilities.
Estimated Economic Impact	Performance and Incentive	Average daily spending rates multiplied by event attendance and duration. Average daily spending rates vary depending on event type (i.e., conventions and meetings, spectator sports and demonstrations, and participant sports and competitions) and attendee type (i.e., local/social visitors, out-of-town visitors, and exhibitors). This methodology was mutually agreed upon by the City and TSJ as a means to estimate consumer spending related to events.
Return on Investment	Performance only	<p>The Management Agreement, its addendum, and amendments outline that the measure of the City's return on investment is based on a set formula. In September 2012, City staff and Team San Jose agreed to a slightly amended formula.</p> <p>In the fall of 2013, City staff and Team San Jose agreed further to leave out certain expenses paid by the Convention and Cultural Affairs Fund, including some capital spending and the management fees paid by the City to TSJ.</p> <p>[gross revenues from the operation of the Facilities] + [estimated economic impact] + [Transient Occupancy Tax revenues allocated to the Convention and Cultural Affairs Fund] + [Convention Center parking garage revenues]</p> <p>divided by</p> <p>[operating expenses of the Facilities] + [some expenses of the Convention and Cultural Affairs Fund, including CVB funding] + [some Facilities debt service] + [Convention Center parking garage expenses]</p>

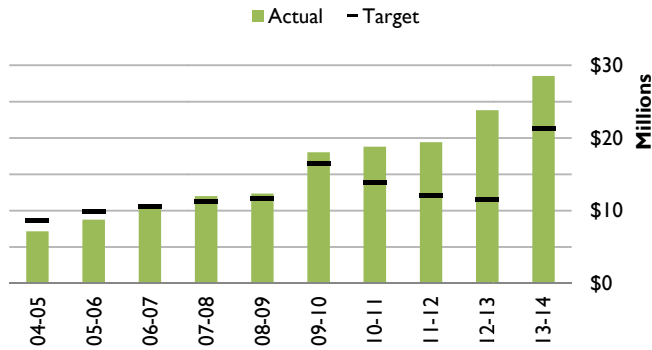
Measures	Type of Measure	Methodology for Calculation
Theater Performance		
Performance Days	Performance and Incentive	<p>All days that the City and TSJ mutually agree are both available and suitable for performance of a scheduled performance or event, and on which a performance indeed takes place. Performance days are measured by the extent to which TSJ maintains or increases use of the theaters on performance days.</p> <p>As discussed above, one location may have multiple “performance days” on one calendar day if there are unique performances (i.e., not a matinee and regular performance of the same show). In addition, performance days may include private performance (i.e., performances of a show that is for select patrons and not open to the public).</p>
Occupied Days	Performance and Incentive	Days that a theater is utilized under contract and not available for booking for other events.
Customer Satisfaction		
Satisfaction Rate	Performance and Incentive	The results of the TSJ's surveys that ask the event coordinators to rate their overall satisfaction with the product and services provided. Responses of “excellent,” “very good,” or “good” are considered satisfactory.

Source: Auditor summary of terms outlined in the Management Agreement, addendum, and amendments, and other issues identified during course of audit work

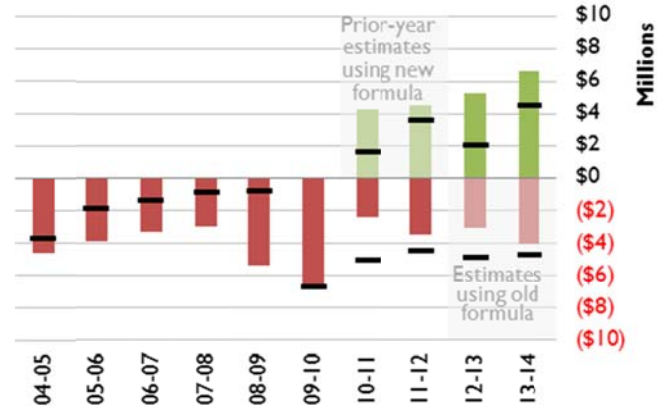
APPENDIX B

Team San Jose Targets and Performance Since FY 2004-05

Gross Revenue

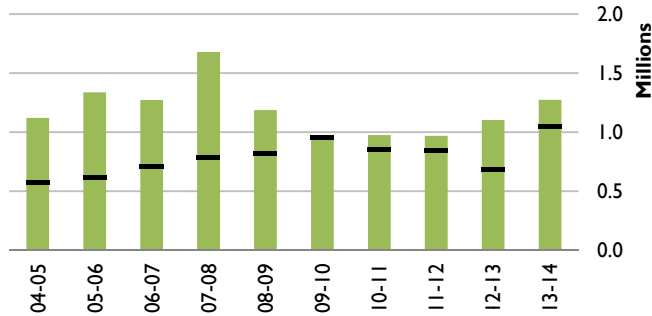


Gross Operating Profit

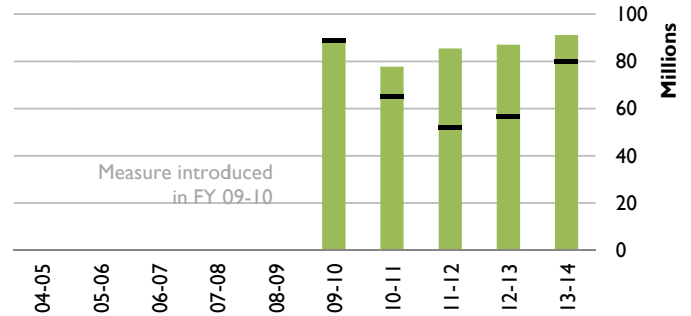


The gross operating profit calculation was modified effective FY 2012-13; the red bars show the old formula, the green bars the new formula.

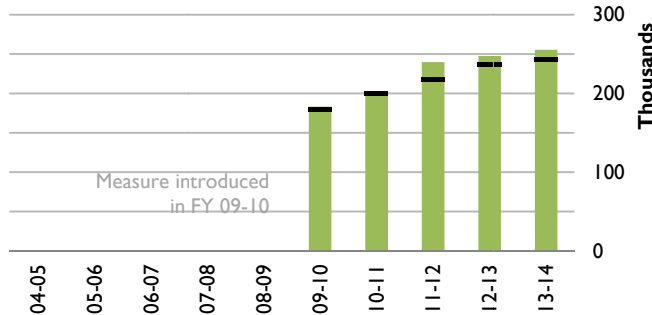
Event Attendance



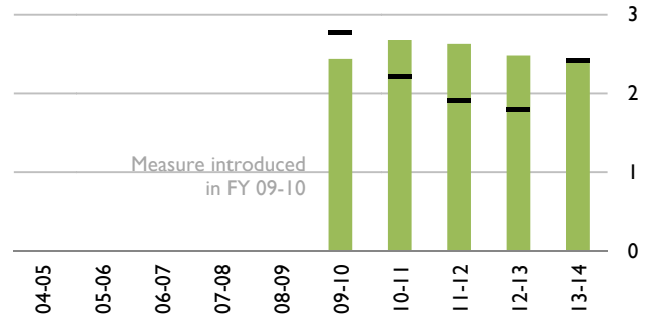
Estimated Economic Impact



Hotel Room Nights

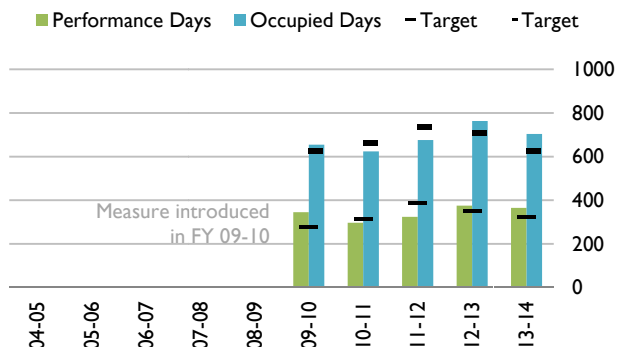


Return on Investment

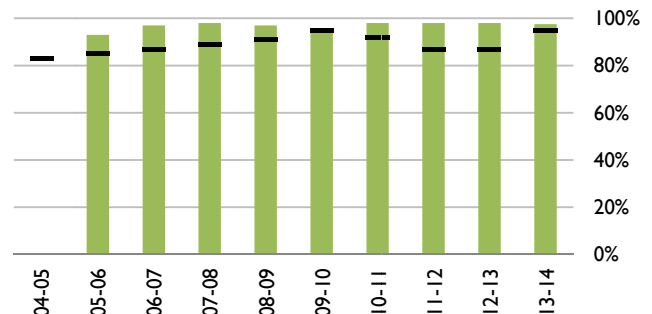


The return on investment components changed in FY 2013-14.

Performance Days and Occupied Days



Customer Satisfaction



Insufficient customer responses in FY 2004-05 to present a meaningful rating.

Source: Auditor analysis of Exhibit 2 and our previous Team San Jose performance audits